Supreme Court, U.S.
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No. 95-1835

In the Supreme Court of the United States

OCTOBER TERM, 1995

DOCTORS HOSPITAL REAL ESTATE, LTD., ETC.,
PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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QUESTIONS PRESENTED

1. Whether the unified partnership audit proceedings established by 26 U.S.C. 6221 may be applied to determine whether a partnership satisfies the noncorporate lessor requirements of Section 46(e)(3) of the Internal Revenue Code (as in effect during the period of this suit).

2. Whether the Tax Court clearly erred in finding that petitioner was reimbursed for the expenses it contributed, as lessor, toward the operating expenses of a hospital.

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OPINIONS BELOW

The per curiam order of the court of appeals (Pet. App. 13) is unpublished, but the decision is noted at 79 F.3d 1144 (Table). The opinion of the Tax Court (Pet. App. 1-10) is reported at 67 T.C.M. (CCH) 2591 (1994).

JURISDICTION

The judgment of the court of appeals was entered on February 6, 1996. The petition for a writ of certiorari was filed on May 6, 1996. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

Petitioner Doctors Hospital Real Estate, Ltd. is a limited partnership. It is therefore subject to the provisions of Sections 6221 through 6233 of the Internal Revenue Code that require the tax treatment of items of partnership income, loss, deductions and credits to be determined in a single proceeding at the partnership level. 26 U.S.C. 6221-6233. The scope of the unified partnership audit procedures—and of judicial review of adjustments made in those audits—is limited to "partnership items." 26 U.S.C. 6221, 6226(f). This case concerns whether the issue of whether petitioner satisfied the noncorporate lessor requirements of Section 46(e)(3) of the Internal Revenue Code—so that its individual partners could claim an investment tax credit—relates to a "partnership item" to which the unified audit provisions apply.[1]

Under Section 46(e)(3)(B) of the Code as then in effect, a noncorporate lessor of property could qualify for the investment tax credit available for certain types of leased property only if two preconditions were met: (i) the term of the lease must have been less than 50 percent of the useful life of the property and (ii) for the period consisting of the first 12 months after the property was transferred to the lessee, the sum of the deductions with respect to the property that were allowable to the lessor under Section 162 of the Code (other than rents and reimbursed amounts)

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[1] Petitioner also claimed in the Tax Court that that court did not have jurisdiction to consider whether petitioner's interest expense for 1984, 1985, and 1986 was investment interest. The Tax Court rejected petitioner's claim, and the court of appeals affirmed. Petitioner does not seek further review of that aspect of the courts' decisions.

must have exceeded 15 percent of the rental income that the lessor received from the property. 26 U.S.C. 46(e)(3)(B) (1982). See Pub. L. No. 94-12, §302(a), 89 Stat. 40 (1975). These two requirements have been referred to, respectively, as the "useful life test" and the "expense test" (Pet. App. 7). They are designed to insure that the lessor is actively engaged in the conduct of the business and is not a passive investor (*ibid.*).

1. In 1979, a group of doctors organized a corporation named Doctors Hospital of Victoria in order to develop and operate a new hospital (Pet. App. 3). After the corporation acquired property as a location for the new hospital, the doctors and others formed petitioner as a limited partnership to develop the property (*id.* at 4). In early 1982, the corporation leased the land to the partnership. The partnership then leased the land and the hospital that was to be built on the property back to the corporation (*ibid.*). Under the hospital lease, the corporation was responsible for all expenses incurred in operating the hospital (*ibid.*). The rent paid by the corporation for use of the hospital was set at the amount the partnership required to service the indebtedness it incurred in constructing the hospital (*id.* at 5).

The doctors decided that they did not have the expertise or financial ability to run a hospital. After the leases between the partnership and the corporation were in place, the doctors sold their stock in the corporation to Universal Health Services, Inc., which was engaged in the business of owning and operating acute-care hospitals (Pet. App. 4). The hospital was thereafter constructed and placed in service in April 1984 (*id.* at 4-5).

At the end of 1984, the parties revised the hospital lease (Pet. App. 5). The revised lease included a lease of fixed equipment and required the partnership to contribute to the operating expenses of the hospital the sum of $550,000 per year (*id.* at 6). The corporation remained responsible under the lease for paying to the partnership the amount required to service the indebtedness incurred in constructing the hospital (*id.* at 5). In addition, the revised lease required the corporation to pay the partnership "additional rent" in the amount of $550,000 per year—the same amount that the partnership was required to contribute to the operating expenses of the hospital (*id.* at 6).

2. On its 1984 federal information tax return, the partnership claimed that it owned property with a basis of $4.3 million that qualified for an investment tax credit to be passed through to each of its individual partners (Pet. App. 11, 18). The Internal Revenue Service issued notices of final partnership administrative adjustment to the partnership for its 1984, 1985, and 1986 taxable years (*id.* at 2). The notice for 1984 indicated that petitioner did not satisfy the statutory prerequisites for investment tax credits applicable to noncorporate lessors under Section 46(e)(3) (Pet. App. 18).

3. Petitioner sought a redetermination of the partnership adjustments in the Tax Court. Prior to trial, petitioner moved to dismiss portions of the case, contending that the Tax Court lacked jurisdiction to determine whether petitioner satisfied the noncorporate lessor requirements of Section 46(e)(3). Petitioner argued that this requirement was not a "partnership item" over which the Tax Court had jurisdiction in a unified partnership proceeding.

The Tax Court denied the motion to dismiss and, after a trial on the merits, upheld the Commissioner's determinations. The court concluded that petitioner, as a noncorporate lessor of the hospital equipment, could qualify for the investment tax credit with respect to that equipment only if it satisfied the "useful life test" and the "expense test" under Section 46(e)(3) of the Code. The court explained (Pet. App. 7-8) that petitioner could not meet the "expense test" because the $550,000 that it contributed towards the operating expenses of the hospital was reimbursed by the corporation and therefore was a "reimbursed amount" within the meaning of the statute. Because the court found that petitioner did not satisfy the "expense test," it did not decide whether petitioner met the "useful life test" (*id.* at 8). The court of appeals affirmed without opinion (*id.* at 13).

ARGUMENT

The decision of the court of appeals is correct and does not conflict with any decision of this Court or any other court of appeals. Further review is therefore not warranted.

1. As in effect during the years relevant to this suit, Section 46(e)(3) of the Code limited the investment tax credit in cases involving noncorporate lessors of property. The tests imposed by that statute must be met before any investment tax credit resulting from petitioner's operations may be allowed. And, as the courts below correctly concluded, application of those statutuory tests to petitioner requires the determination of a "partnership item" over which the Tax Court had jurisdiction under 26 U.S.C. 6221, 6226(e).

The statute defines the term "partnership items" to mean "any item required to be taken into account for the partnership's taxable year * * * to the extent regulations prescribed by the Secretary provide that * * * such item is more appropriately determined at the partnership level than at the partner level." 26 U.S.C. 6231(a)(3). The regulations issued by the Secretary under this statute provide that "partnership items" include "[i]tems of * * * credit of the partnership" as well as "[o]ther amounts determinable at the partnership level with respect to partnership * * * transactions and operations necessary to enable the partnership or the partners to determine the investment tax credit" (26 C.F.R. 301.6231(a)(3)-1(a)). The regulation thus specifically requires that application of the requirements of Section 46(e)(3) to petitioner is to be determined "at the partnership level" in order "to determine the investment tax credit" for all partners in a unified proceeding.

Petitioner does not claim that the straightforward application of this regulation by the courts below conflicts with any decision of this Court or any other court of appeals. Instead, petitioner claims only (Pet. 5, 11) that the reasoning of the Tax Court's opinion conflicts with decisions of the Fifth Circuit and of the Tax Court in *Sealy Power, Ltd.* v. *Commissioner*, 46 F.3d 382 (5th Cir. 1995); *Alexander* v. *United States*, 44 F.3d 328 (5th Cir. 1995); *Hambrose Leasing* v. *Commissioner*, 99 T.C. 298 (1992); *Hayes* v. *Commissioner*, 69 T.C.M. (CCH) 2323 (1995); and *Gemini Twin Fund III* v. *Commissioner*, 62 T.C.M. (CCH) 104 (1991), aff'd, 8 F.3d 26 (9th Cir. 1993) (Table). Petitioner's allegation of an intra-circuit conflict and of a conflict within the Tax Court itself would not,

even if true, warrant review by this Court. But the suggestion that these decisions are in conflict is erroneous in any event, for it does not take into account the distinct factual contexts of these cases. In particular, none of the cases on which petitioner relies involves the question presented here—whether a unified proceeding should be employed "to determine * * * [t]he investment credit" resulting from a partnership's activities, as the regulation expressly requires (26 C.F.R. 301.6231(a)(3)-1(a)).[2]

Whether an issue is more appropriately determined at the partnership level or at the partner level depends upon whether it is a matter that must be determined with reference to the partnership and would affect the partners uniformly or, instead, is a matter that may be resolved differently for different partners, based upon their individual circumstances. The decision in this case is in complete harmony with that principle.

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[2] *Sealy Power* did not involve the definition of partnership items. Instead, it addressed the validity of a notice of partnership adjustment that the taxpayer claimed was arbitrary and capricious. 46 F.3d at 385. *Alexander* was concerned with the point in time at which a partnership item becomes a non-partnership item. 44 F.3d at 331. In *Hambrose*, the court held that the determination of a partner's amount "at risk" with respect to partnership liabilities was not a partnership item because it turned on circumstances and arrangements unique to each individual partner. 99 T.C. at 310. *Hayes* was not concerned with the definition of partnership item, but was merely a partner-level proceeding following *Hambrose*. 69 T.C.M. (CCH) at 2326. And the court in *Gemini Twin Fund III* merely noted that Tax Court decisions, such as *Hambrose*, had held that the determination of a partner's amount at risk was not a partnership item. 62 T.C.M. (CCH) at 107.

2. The Tax Court found that petitioner was fully reimbursed for the $550,000 that it ostensibly contributed to the operating expenses of the hospital and that petitioner therefore did not satisfy the "expense test" of Section 46(e)(3). That finding was sustained by the court of appeals. Further review of that factual determination, concurred in by the two courts below, is not warranted. See *Tiffany Fine Arts, Inc.* v. *United States*, 469 U.S. 310, 317-318 n.5 (1985).

Petitioner errs in contending (Pet. 15-18) that the court's finding on this factual issue conflicts with this Court's decision in *Frank Lyon Co.* v. *United States*, 435 U.S. 561 (1978). In *Frank Lyon*, the Court held that an arrangement under which a bank sold a building to the taxpayer and simultaneously leased it back from the taxpayer had real econcomic substance and should be recognized for tax purposes. *Id.* at 582-583. That decision has nothing to do with this case. The Tax Court in this case did not conclude that the existence of the various leases and leasebacks should be disregarded. Instead, the court concluded that the terms of those very leases resulted in such substantial reimbursement of costs to petitioner that petitioner did not satisfy the "expense test" of Section 46(e)(3). Nothing in *Frank Lyon* would require any different conclusion in this case.[3]

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[3] Petitioner's further contention (Pet. 18-25) that it was deprived of a fair trial because it "had no reason to prepare for trial on the noncorporate lessor issues" (Pet. 20) is frivolous. The notice of partnership adjustments issued to petitioner stated that "you [petitioner] have not established that any property in excess of that allowed meets the requirements for noncorporate lessors as provided by Section 46 of the Internal

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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Revenue Code" (Pet. App. 18). The noncorporate lessor issue was thus directly and properly before the Tax Court.

Petitioner also plainly errs in contending (Pet. 21-25) that the Tax Court abused its discretion in refusing to admit certain proffered evidence. As the Tax Court explained, the evidence that was not admitted was either already before the court or was irrelevant to the case (see *ibid.*). In any event, the evidentiary complaints now raised by petitioner were not addressed by the court of appeals, do not present any conflict among the circuits and do not warrant review by this Court.